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PRE-ELECTION OUTLOOK NOVEMBER 2012

As one enormous Atlantic storm recedes into memory, the metaphorical storm brewing over Washington only looks more ominous. In the days leading up to the 2012 election, no shortage of economic policy hangs in the balance, with little certainty as to who will prevail. Indeed, so tight is the race that recounts and legal challenges could postpone resolution for days, making it distinctly possible that Wednesday morning won't deliver finality.

HIGHLIGHTS

- November 6th Fast Approaching
- Indicators Suggest Slight Obama Edge
- Fiscal Cliff Looms Post-Election

Caprin's pre-Election 2012 outlook focuses on:

- **(Obviously) Who wins?**
- **How does this outcome impact the impending Fiscal Cliff?**
- **What does it all mean for fixed income investors?**

Whoever wins, gridlock and dysfunction in Washington are all but guaranteed to worsen into 2013, in an economy that literally cannot afford that environment. "The election may answer some near-term questions," says Scott Eldridge, CFA, Caprin's director of portfolio management. "But regardless of who wins, there remain pressing long-term questions, led by how the U.S. plans to address its fiscal crunch."

While the average of polls tracked by Real Clear Politics now places Mitt Romney and Barack Obama at a statistical dead heat, state-by-state tallies give Obama a more likely path to an Electoral College victory. It could all come down to an Ohio or Virginia, two states that have historically been essential to a GOP presidential win. Intrade places the likelihood of an Obama win at 66%, the U.S. Senate remaining Democrat-controlled at 71% and the House under Republicans at 96%.

Barring an unlikely GOP White House-Senate-House trifecta, investors will have to brace for rapidly heightened anxiety over $500 billion in combined tax hikes and spending cuts that can kick in on January 1, 2013 – the proverbial slide down the Fiscal Cliff. If Romney wins, the bottleneck to a negotiated deal will become the Senate's Democratic leadership; if Obama wins, he and the GOP-controlled House will have to discover an appetite for cooperation that has evaded them throughout Obama's first term. The stakes are huge: the Congressional Budget Office estimates the Fiscal Cliff could slice 3.9% from 2013 economic growth.

Elsewhere, Ben Bernanke, the man behind the Federal Reserve's unprecedented accommodation, is up for reappointment in 2014 (a year before the Fed's stated 2015 target date for its zero interest rate policy). A Romney presidency is widely viewed to be less amenable to more Bernanke. Booming bond markets might not be pricing in the risk of monetary hawkishness.

The preferred taxation of municipal bonds is also in question. In an environment starved for fiscal revenue, Tax–exempt / Tax Credit Bonds represent close to a 4 percent share of all tax expenditures. The Obama budget proposes a cap at 28% for all munis, retroactively. The Simpson/Bowles plan, which remains largely symbolic in Washington, eliminates the exemption on future issues. "Everything is on the table," remarked the chairman of the Senate Finance Committee in April.

Says Eldridge: "It's unclear to us that either candidate has the willingness to make the tough decisions, or the ability to work with the other party to get things done." All told, we see no shortage of political uncertainty, in a market environment that has been "risk-on" complacent for much of this year.

Look for our post-Election view next week.

1802 Bayberry Court, Suite 202
Richmond, Virginia 23226
804] 648-3333
CAPRINBONDS.COM